

THE ECONOMIC OUTLOOK GROUP



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ECONOMIC TALKING POINTS

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Initial Reaction To The Deficit Reduction Proposals

Let's begin with the obvious. The task of shrinking both the deficit and the national debt is immensely difficult because it is dependant upon the future path of the economy and a hornet's nest of reforms in spending and tax policies. Getting a political consensus on how to restore sanity to fiscal policy will require courage and bi-partisanship on a scale we have not seen in a long time. It's particularly hard to imagine such cooperation in the near future given the rabid contentiousness in Congress. We should thus laud all serious proposals that help move the nation closer to those goals. The exploding annual deficits and the cumulative national debt are not only unsustainable, they threaten the triple-A credit rating of the US. The mere whiff that America may lose its sterling credit record would cause foreign investors to shun the U.S., an event that would quickly translate into crippling high interest rates. So clearly something has to be done to end the deterioration in federal finances.

The proposals put forth by the fiscal commission are serious and worthy of discussion. None ought to be viewed as "dead on arrival." Having said that, we do have to proceed cautiously and make sure that the enactment of these recommendations does not backfire on the economy. Americans are still in a fragile state, having just survived the worst economic downturn since the Great Depression. More than a year and half has passed since the recession ended, yet the unemployment rate hovers near 10%.

Consumers as well as banks are still healing from wounds left after years of excessive leveraging. The point I want to make is that while Congress and the White House should move expeditiously to reassess our budgetary priorities, the process has to be done carefully, deliberately, and with sensitivity to the delicate state of where the economy now stands in the business cycle.

Let's begin with the goal of the commission. President Obama instructed the fiscal commission to come up with a plan that would reduce the annual deficit to about 3% of GDP by 2015, from its current level of 9%. After several months of deliberation, the panel introduced a preliminary 50-page report containing several controversial proposals that actually better what the President sought by dropping the deficit to 2.2% of GDP in 2015. According to the report, the path to that goal will require draconian cuts in domestic spending and the elimination of many sacred tax deductions. To offset the pain and expected public outcry, the fiscal commission called for lower personal and corporate taxes, along with the repeal of the much-hated AMT. Implementing all their proposals would save more \$3.8 trillion over the next decade. Presently, the budget is projected to accumulate \$8 trillion in deficits the next ten years.

So what's next? For the fiscal commission report to be formally submitted to Congress for action, 14 out of 18 commission members must approve of the plan's recommendations. That will not be easy since the group is equally divided between Democrats and Republicans and some simply do not want to be identified with some of the plan's more controversial suggestions to shrink the deficit.

Frankly, I, too, have some concerns with their plan. I am wary of the timing of the report and specifically question the wisdom of the size of the spending cuts proposed. These are not normal times. As I mentioned earlier, the US has recently emerged from the worst recession in seventy years, an event that was triggered by a near catastrophic collapse of the global financial system. Governments around the world were forced to spend trillions in an emergency rescue effort to prevent another world economic depression. That surge in official spending bloodied budgets everywhere, but especially so in the U.S. Yet the strategy has succeeded and the global economic recovery is back on track. True, the U.S. recovery has been lackluster lately and this has temporarily locked us into large annual cyclical deficits. But I find it odd to use this moment as the jumping point to quantify how many trillions in spending cuts and revenue increases will be needed over the next ten years to correct both the cyclical and structural imbalances in the budget.

For example, our expectation is that the US economy will grow considerably faster next year and in 2012 than most forecasters have projected, and this will almost certainly bring in more tax revenues than the depressed projections the commission has based their work. A stronger economy will do much to shrink the current cyclical deficit and that will allow Washington to better focus on the steps necessary to fix the more intractable

structural deficit. (Remember, just a decade ago the US economy generated record budget surpluses!)

But there is a broader philosophical issue here as well. The mere enormity and sensitivity of the cuts recommended are unprecedented. They include eliminating deductions on home mortgage interest expenses, increasing the retirement age for social security, reducing Medicare benefits and raising its premiums, significantly cutting defense spending, canceling funds for Public Television, increasing co-pays for veterans and even establishing deductibles for them, raising the federal gas tax to 15 cents a gallon within three years, and terminating all earmarks.

Give the tectonic changes proposed, it seems appropriate to have some sort of national referendum on the budget. Few argue the need to reduce, if not eliminate out year deficits. But when the fiscal reforms proposed are of such historic magnitude and consequence, when the changes will affect every American in a dramatic, personal and material way for decades to come, shouldn't Americans have some direct input? I think so. How this would take shape has to be worked out. But every American really needs to address two fundamental questions about the entire budgetary process:

What do you really want from government? And second, how do you want to pay for it?

Such a national referendum would be critical for at least two reasons. The inclusiveness of individual Americans in the national debate is essential in this case. They are the ones that will feel the effects of such sweeping reforms the most. Of course, some will disagree and argue that this is what elections are all about and that to hold everything up just to get the of feedback of Americans not only wastes time, but usurps the role of policymakers in Washington. I disagree. The stakes for Americans are too large and the sacrifices too palpable.

Moreover, by overtly soliciting what Americans think ought to be the nation's budgetary priorities in the decades to come ---and how they should be financed ---will in the end also make it more politically palatable for Congress to enact such historic legislation.

The decisions made over the budget will have a lasting and profound impact on Americans for generations. Since no one has a monopoly on wisdom in Washington, this is one of those rare moments in public policy where the direct participation by Americans on the debate over the budget can only help.